

Little Rock - North Little Rock, AR

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1,000 feet		
> 1,000 feet		

Revised Los Angeles-Long
Beach/Anaheim-Santa Ana-Garden
Grove/Riverside-San Bernardino-Ontario,
CA

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1000 feet		
> 1000 feet		

REDACTED - FOR PUBLIC INSPECTION

Madison, WI

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1000 feet		
> 1000 feet		

REDACTED - FOR PUBLIC INSPECTION

Milwaukee, WI

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 100 feet		
≤ 300 feet		
≤ 500 feet		
≤ 1,000 feet		
> 1,000 feet		

New Haven-West Haven-Waterbury-Meriden, CT

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1,000 feet		
> 1,000 feet		

Oklahoma City, OK

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1,000 feet		
> 1,000 feet		

Reno, NV

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1,000 feet		
> 1,000 feet		

Rockford, IL

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1,000 feet		
> 1,000 feet		

Sacramento, CA

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1,000 feet		
> 1,000 feet		

San Antonio, TX

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1,000 feet		
> 1,000 feet		

REDACTED - FOR PUBLIC INSPECTION

San Diego, CA

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1000 feet		
> 1000 feet		

San Francisco-Oakland-Fremont, CA

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1,000 feet		
> 1,000 feet		

San Jose, CA

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1000 feet		
> 1000 feet		

REDACTED - FOR PUBLIC INSPECTION

South Bend-Mishawaka, IN

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1000 feet		
> 1000 feet		

St. Louis, MO-IL

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1,000 feet		
> 1,000 feet		

Stockton, CA

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1,000 feet		
> 1,000 feet		

Tulsa, OK

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1,000 feet		
> 1,000 feet		

Wichita, KS

Distance from Known Alternative Fiber	% DS1s Within Distance	% DS3s Within Distance
≤ 500 feet		
≤ 1,000 feet		
> 1,000 feet		



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**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554**

_____)	
In the Matter of)	
)	
Special Access Rates for Price-cap Local)	
Exchange Carriers)	WC Docket No. 05-25
)	RM-10593
AT&T Corp. Petition for Rulemaking to Reform)	
Regulation of Incumbent Local Exchange Carrier)	
Rates for Interstate Access Services)	
_____)	

**STATEMENT OF
PROFESSOR JOSEPH P. KALT
ON BEHALF OF SBC COMMUNICATIONS INC.**

June 13, 2005

I. INTRODUCTION

A. Witness Identification and Qualifications

1. My name is Joseph P. Kalt. I am the Ford Foundation Professor of International Political Economy at the John F. Kennedy School of Government, Harvard University, Cambridge, Massachusetts 02138. In addition, I work as a senior economist with Lexecon, an FTI Company, 20 University Road, Cambridge, Massachusetts 02138. Lexecon is an economics consulting firm specializing in matters of antitrust and regulated industries.

2. I hold B.A., M.A., and Ph.D. degrees in economics and am a specialist in the economics of competition and antitrust, with particular emphasis on regulated industries. Throughout my professional career I have conducted research, published, taught, and testified extensively on the economics of competition and regulation.

3. At Harvard, I served as an Instructor, Assistant Professor, and Associate Professor in the Department of Economics (1978-86) prior to joining the faculty of the Kennedy School of Government as a Professor with tenure in 1986. In the Department of Economics, I had primary responsibility for teaching the graduate and undergraduate courses in the economics of regulation and antitrust. At the Kennedy School, my teaching responsibilities have included the economics of regulation and antitrust, economics of public policy, and natural resource and environmental policy. I have also been the Kennedy School's Academic Dean for Research, Faculty Chair of the Environmental and Natural Resources Program, Faculty Chair of the Economics and Quantitative Methods Section, Chair of Degree Programs, and Chair of Ph.D. Programs.

4. As summarized in my accompanying curriculum vitae (Attachment 1), I have studied extensively the economics and political economy of economic regulation, with particular emphasis on price regulation and with particular regard to network industries such as telecommunications, railroads, pipelines, and the like. I have provided testimony

as an expert before numerous state, federal and international courts, as well as before many state and federal regulatory commissions.

B. Scope of Testimony

5. On January 31, 2005, the Federal Communications Commission (FCC or Commission) issued an Order and Notice of Proposed Rulemaking (NPRM), seeking comment on the appropriate regulation of special access services provided by price-cap local exchange carriers (price-cap LECs) following the pending expiration of the current regulatory framework, the *CALLS Order*, on June 30, 2005. As part of the investigation, the FCC seeks comment on issues arising from traditional price-cap regulation; the appropriate post-*CALLS* regulatory regime; and the efficacy of the Commission's standards, established in the *1999 Pricing Flexibility Order*, for providing price-cap LECs pricing relief in areas where they face competition in the market for special access services.

6. I have been asked by SBC Communications, Inc. (SBC), to comment on various aspects of the NPRM. In particular, SBC has asked me to comment on: the effectiveness of the policies adopted in the *Pricing Flexibility* and *CALLS Orders* in achieving the Commission's goal of fostering competition in the special access market; the economic and public policy principles that are implicated as the Commission contemplates modifications to the current regulatory framework; and the economic considerations that should guide the Commission as it evaluates various parties' proposals for a post-*CALLS* regime.

7. Following this initial summary, Section II of my testimony discusses the public policy and economic principles that provide the foundation for sound regulatory decisionmaking regarding special access services, as well as the consequences of price regulation in an evolving and increasingly competitive marketplace. I focus, in particular, on the difficulty of regulatory price-setting and explain how undue regulation in emerging competitive markets can chill investment, innovation, and competitive entry.

8. Section III of my testimony examines competitive progress in the special access market since the adoption of the *Pricing Flexibility Order*. With respect to the economic goals of the Price-Flex/*CALLS* regime, I examine the current state of competition in those regions in which SBC has been granted Phase II relief—including an examination of competitor entry, competition among service providers, prices, and SBC's responses to these changes. Based on the trends and developments in the markets where SBC operates, I investigate whether the Price-Flex "triggers" have accurately identified the market segments in which price-cap regulation can reasonably be eschewed in favor of granting a greater role to the market forces of innovation and competition in protecting consumers' interests.

9. Section IV discusses policy recommendations for the Commission to consider as it determines how to replace the expiring *CALLS Order* with a new regulatory regime. In particular, I address the efficacy of AT&T's calls for revamped price-caps and stronger regulation. I also examine the economic and policy implications of other questions posed by the Commission in its NPRM—for example, the advisability of creating smaller "baskets" for regulation of special access services, reinitializing special access rates using the 1991 rate-of-return level of 11.25%, and reimposition of automatic price-reduction formulas in the form of "X-" or "g-" factors.

C. Summary of Conclusions

10. The current marketplace is in the midst of an evolution toward the effective competition envisioned by Congress in the Telecommunications Act of 1996 and the FCC under its Price-Flex/*CALLS* regime. In a broad sample of markets where SBC has received Phase II price-cap relief, available evidence on price trends, competitor entry, and the presence of (and potential for) competing technologies indicates a strong positive trajectory toward full competition. In market after market, large and small, there has been steady net entry of providers who compete with the price-cap LECs; average prices for special access services have declined; and new service and rate offerings have emerged to offer consumers greater choice and flexibility.

11. I conclude that the Commission's Price-Flex/*CALLS* policy has been a demonstrable success at balancing the goals of (i) protecting consumers in areas where there is not yet full competition and (ii) fostering the movement toward market-determined pricing, service choices, and competitor entry. Evidence across SBC's territory indicates that there is no need to reimpose price-caps in Phase II regions or, in the remaining regions, to reinitialize price-cap levels or lower them through application of an X-factor or g-factor. Such measures could only discourage competitive entry, investment, and innovation in competitive technologies.

12. I further conclude that for certain services, including packed-switched service and OCn-level transport and channel termination, robust competition is exhibited across the board. Sound policy principles recommend their categorical exemption from price-caps. For other services, the Price-Flex triggers have reasonably and effectively identified markets in which competitive conditions are ripe for more flexible pricing by price-cap LECs. In fact, although the competitive triggers established by the *Pricing Flexibility Order* have worked well as indicators of competition, because the triggers focus on collocation of competitors in LECs' wire centers, they undercount the degree of competitiveness an LEC faces in any particular Metropolitan Statistical Area (MSA) because they do not account for the increasingly active competitors who bypass the LEC wire centers entirely. These competitors include owners of competitive fiber and related facilities, cable companies, and fixed wireless providers.

13. In short, the market evidence does not support calls for retrenchment from the deregulatory path of the Price-Flex/*CALLS* regime. In particular, it would be counterproductive to the public's interest in the continuing development of dynamic, efficient, and competitive special access services to roll back the Price-Flex/*CALLS* framework by reigning in the move toward pricing and service flexibility. Changing the "rules of the game" by reimposing, reinitializing, or otherwise tightening price regulation would chill entry, innovation, and deployment of new facilities, all to the detriment of consumer welfare.

14. The particular suggestions for post-CALLS reregulation of the special access market are unnecessary and counterproductive. A price-cap regime interrupted by periodic reinitializations designed to reimpose “appropriate” rates of return would amount to a form of rate-of-return regulation. The Commission has wisely moved away from that paradigm; it does not fit a technologically dynamic and increasingly competitive industry such as special access services. A retrogression to rate-of-return regulation would raise all of the regulatory problems that warranted the move to price-cap regulation in the first place. Not only would such regulation have counterproductive impacts on incumbent price-cap LECs’ incentives to be efficient and innovative, but it also would magnify the problems faced by regulators attempting to allocate inherently shared and un-allocable joint and common network costs to individual services (or a basket of selected services).

II. THE PUBLIC POLICY AND ECONOMICS OF PRICE REGULATION IN THE SPECIAL ACCESS MARKET

A. The Limits of Effective Price Regulation

15. As a general matter, free competition best serves the interests of the consumer. In competitive markets, the forces of the marketplace create proper incentives for entry, investment, pricing, productivity, and innovation. Firms in competitive settings have particularly strong incentives to improve their products and to lower their costs, and those incentives adapt quickly to changes in the market, facilitating the efficient deployment of resources as market conditions change. The discipline of competition, moreover, pushes prices toward costs, as competitors continue to bring supplies to market in the short run so long as prices cover the incremental costs of those supplies, and expansion by firms in response to profit opportunities eliminates excess profits by pushing prices in the long run toward average economic cost.

16. Notwithstanding the foregoing, if an industry is subject to unusually large economies of scope and scale and barriers to entry, unregulated market forces may not succeed in optimally serving consumers’ interests. Under these conditions, unregulated competition may sometimes allow a single large firm realizing cost-reducing economies

of scale and scope to underprice all of its competitors such that those competitors leave the market. At this point, if protected by substantial barriers to entry, the large remaining firm might find it profitable to hold supply below its optimal level, thereby driving up prices to consumers. This sends distorted signals to the effect that a good or service is more scarce than it really is or needs to be. In those cases, government regulation of prices—if it can be effectively implemented—can serve the public's interest in a healthy and efficient economy by blocking the incumbent firm's ability to restrict supply and drive up prices.

17. While it can help mitigate the ill effects of a market that is not, or not yet, competitive, price regulation, if not done perfectly, will itself distort marketplace incentives and economic behavior. In the process, the cure can be worse than the disease. This is not an ideological criticism of regulators or regulation. Rather, sound public policy recognizes that regulation is implemented by real people confronted with real problems of limited information, scarce regulatory resources, non-economic political pressure, procedural necessities, and inherently dynamic economic environments. Regulatory instruments such as price ceilings are inherently blunt and imprecise. At the same time, relevant information from the marketplace—products, customers, technology, and costs—is infinitely detailed and variegated. Regulation can remove incentives for firms to hold their costs down; it can bias entry conditions against the innovative; and it can send consumers distorted signals as to the cost and scarcity of resources. These realities create a strong public interest in relying on the forces of competition and the micro-decisionmaking of myriad marketplace participants to set prices, determine outputs, discipline costs, induce investment, and foster innovation and productivity whenever and wherever possible.

18. Hence, promoting the development of competitive markets—and eliminating regulatory intervention as those markets become competitive—is a critical task of policymakers overseeing traditionally regulated, but evolving, industries. Sound public policy uses price regulation to try to correct inefficiencies in markets lacking competition, and even then relies on regulation only judiciously and realistically. The goal of sound

price regulation is to act as a proxy, albeit an imperfect one, for the forces of competition by setting prices that create incentives for innovation and investment similar to those in a competitive market. As competition develops in a market, and the imperfect proxy of regulation is no longer needed, sound public policy calls for its elimination. In fact, undue regulation of competitive markets imposes substantial costs on firms and consumers by distorting the incentives for production, investment, innovation, and consumption.

B. Implications of Price Regulation in Otherwise Competitive Markets

19. Undue regulation that constrains price above or below the price that would prevail in a competitive market leads firms to base their decisions not on the true value the economy places on a particular good or service, but instead on the value the regulator assigns to that good or service. Basing decisions on distorted regulated prices leads firms—both regulated and unregulated—to make inefficient entry, investment, supply, and innovation decisions. Setting a floor for prices in a competitive market above the price levels which would occur without regulation pushes inefficient competitors to enter or remain in markets when, in the absence of regulation, they would choose to deploy their resources elsewhere. Setting a cap on prices in an otherwise competitive market below those which would occur without regulation reduces the incentive for regulated and unregulated firms to innovate, discourages entry by new competitors, and can threaten the viability of regulated firms and their regulated service offerings.

20. Prices also provide a signal to consumers of a product's value. Based on the prices for goods, consumers choose whether to buy a particular product and, if so, how much of the product to buy. If a regulator sets prices in a competitive market higher or lower than the price which would prevail without regulation, consumers will make inefficient choices about which and how much of a given product or service to purchase. Only if regulated prices are equal to those that would prevail in the competitive market will firms and consumers make efficient production and consumption decisions. The challenge for the regulator, of course, is hitting that ideal target. Left unregulated, the *process* of competition in a market can identify competitive prices and generate

incentives for efficient performance. In the case of the regulator, on the other hand, reaching explicit *decisions* as to appropriate prices, parameters of service offerings, and the like is problematic and subject to the vicissitudes of litigation and political processes. Efficient prices depend both on the value consumers place on the good and on the economic cost of supplying the good to the market—both of which are difficult to estimate and decide upon under the best of conditions.

21. Moreover, markets for goods and services are constantly evolving—as costs, technologies, consumer demands, and the like change exogenously and endogenously. Firms invest to lower production costs or increase output and innovate to attract the business of consumers by offering them more valuable products. Consumers also contribute to the evolution of markets and industries by identifying new uses for existing products and seeking out alternative products that better suit their needs. The perpetual evolution of markets implies that, even if a regulator sets prices correctly at a particular point in time, changes in the market will cause the regulated price to diverge from the desired target. In a competitive market, on the other hand, changes in supply and demand are incorporated into the market price more or less automatically. At best, regulation can only roughly mimic competitive market forces. Unduly applied to a competitive market, price regulation makes for poor and costly public policy. To the extent that competition develops in a regulated market so as to discipline prices, sound economics calls for the deregulation of the market.

C. Regulatory Predictability and Consistency

22. In addition to attempting to implement the outcomes of competitive processes and knowing when to let market forces take over this task, a further hallmark of sound regulatory policy is *predictability*. The ability of regulatory policy to emulate the forces of competition and create strong incentives for innovation and investment is linked fundamentally to market participants' expectations of future regulation. If, based on the past actions of the regulator, firms believe the future regulatory environment is uncertain or subject to inconsistent and vacillating application, they will have less incentive to invest in new products, innovation, or facilities.

23. It is particularly important to avoid regulatory uncertainty in a price-cap regime. The efficacy of incentives created by such a regime depends crucially on the benefits a firm expects to earn through cost reductions. If regulators signal to a firm that they may ratchet down the level of the price-cap in response to increased returns, they will drastically reduce incentives for cost reduction and innovation. Moreover, this effect would not necessarily be limited to the market in question. Unexpected regulatory decisions appropriating the benefits of cost-reductions in one industry may affect a government's credibility in other industries.

24. Effective regulatory policy requires that the regulator be able to credibly commit to a regulatory regime that is guided by a coherent (i.e., consistent and predictable) framework. Unexpected, inconsistent regulatory changes, particularly those that change the "rules of the game" so as to deny regulated firms the benefits of their efficiency and innovation, send a strong negative message to firms and substantially undermine investment and innovation incentives. Throughout the world, unstable and unpredictable regulatory rules are preeminent sources of industrial stagnation and underdevelopment.¹

III. ASSESSING THE EFFECTIVENESS OF THE COMMISSION'S PRICING FLEXIBILITY REGIME

A. The Economics of the Price-Flex/*CALLS* Regime

25. The evolution of the Commission's regulation of special access services has been, to this point, a generally coherent response to a changing industry that is consistent with the economics set out above. The contemporary challenge faced by the Commission, however, is how to adapt regulation going forward as the special access service market continues to evolve away from a market that requires price regulation. Recent years have seen strong growth in the indicia of competition, including exponential increases in traffic

¹ See, e.g., Douglass C. North, *Institutions, Institutional Change, and Economic Performance*, Cambridge University Press, 1990.

volumes and demand for sophisticated data services,² a reduction in the sunk assets required for deployment, increasing technological options for complete bypass of the incumbent LEC networks, and pathbreaking new intermodal options. All of these factors have produced efficient and competitive fragmentation of previously monolithic services.

26. Through 1990, interstate special service access charges were subject to old-style rate-of-return regulation. In 1991, the Commission moved to an “incentive ratemaking” system of price-caps. These caps were set initially at the prices generated by the Commission’s 11.25% allowed rate of return, but then were adjusted according to formulas that moved initial caps upward on the basis of economy-wide inflation and downward on the basis of predicted sector growth and productivity. By divorcing maximum prices from the individual firm’s (or service’s) costs, the Commission gave the price-cap LECs incentives to be more efficient: if a firm could find ways to cut its costs below the level of the price-cap, it would have the prospect of retaining some profit from its efforts and investments. This contrasts with strict rate-of-return regulation, which chills such incentives by imposing price reductions to match cost reductions.

27. Though initially the Commission diluted its price-cap regime by requiring carriers to “share” higher earnings with customers, the Commission abandoned profit-sharing because it presented the same types of disincentives as rate-of-return regulation.³ With “sharing” now abandoned, the Commission has correctly concluded that “[p]rice cap regulation encourages incumbent LECs to improve their efficiency by harnessing profit-making incentives to reduce costs, invest efficiently in new plant and facilities, and

² See Declaration of Alfred E. Kahn and William E. Taylor on Behalf of BellSouth Corporation, Qwest Corporation, SBC Communications, Inc., and Verizon at 3-4. See also, UNE Fact Report 2004, Prepared for and Submitted by BellSouth, SBC, Qwest, and Verizon, at III-1-III-5.

³ Order and Notice of Proposed Rulemaking, *Special Access Rates for Price-cap Local Exchange Carriers; AT&T Corp. Petition for Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, 20 FCC Rcd 1994, 2007 ¶ 32 (2005) (“Notice”). See also, Fourth Report and Order, *Price-cap Performance Review for Local Exchange Carriers*, 12 FCC Rcd 16642, 16645, 16650, 16698-16700 ¶¶ 1, 14, 144-49 (1997) (“1997 Performance Review Order”).

develop and deploy innovative service offerings, while setting ceilings at reasonable levels...[P]rice caps act as a transitional regulatory scheme until the advent of actual competition makes price-cap regulation unnecessary.”⁴

28. In the wake of the Telecommunications Act of 1996 and its endorsement of market forces as preferred regulators of telecommunications prices, the Commission adopted its *Pricing Flexibility Order* in 1999.⁵ At present, Phase I (downward) price flexibility in an MSA requires evidence that unaffiliated carriers have collocated in 15% of a price-cap LEC’s wire centers in that MSA, or that the LEC’s wire centers where competitors have collocated account for at least 30% of the LEC’s special access service revenues.⁶ Phase II (upward) flexibility triggers are more stringent—requiring that at least 50% of wire centers host collocators, or that the wire centers hosting collocators account for at least 65% of the price-cap LEC’s special access service revenues.⁷ In setting these triggers, the Commission characterized the pricing flexibility rules for special access as part of the process “to reform regulation of interstate access charges in order to accelerate the development of competition in all telecommunications markets and to ensure that our own regulations do not unduly interfere with the operation of these markets as competition develops.”⁸

⁴ Notice at 1998-99 ¶ 11.

⁵ Fifth Report and Order and Further Notice of Proposed Rulemaking, *Access Charge Reform; Price-cap Performance Review for Local Exchange Carriers*, 14 FCC Rcd 14221, 14224 ¶ 1 (1999) (“*Pricing Flexibility Order*”).

⁶ Phase I flexibility allows price-cap LECs to offer volume and term discounts and contract tariffs unconstrained by otherwise applicable rules, but requires them to hold out a backstop standard offer to customers at prices no higher than the applicable price-cap. Consistent with concerns about difficulties of bypass competition at points of channel termination, in the case of channel terminations between an LEC end office and an end user’s premises, the triggers are set more stringently—at 50% and 65%, respectively.

⁷ Notice at 2001-02 ¶ 17 & n.56. In the case of channel terminations between an LEC end office and an end user’s premises, the triggers are 65% and 85%, respectively.

⁸ *Pricing Flexibility Order* at 14224 ¶ 1.

29. In May 2000 the Commission adopted the *CALLS Order* which, in part, established new procedures for regulating the price of special access services under price-caps and the *Pricing Flexibility Order*.⁹ In adopting the *CALLS Order*, the Commission reiterated its focus on promoting competition in the special access market: "The Commission hoped that, by the end of the five-year *CALLS* plan, competition would exist to such a degree that deregulation of access charges for price-cap LECs would be the next logical step."¹⁰

B. Growth of Competition in Price-Flex Special Access Service Markets

30. The available evidence does not support contentions that pricing flexibility under *CALLS* has permitted price-cap LECs to exercise market power. More and more competitors continue to enter the market, indicating the absence of competition-impeding barriers to entry. These new entrants include those that utilize certain price-cap LEC services and those that completely bypass any need to use such services. They are steadily eating into the market shares of price-cap LECs like SBC, and the average prices of those LECs and their competitors continue a steady trend downward. With these results in hand, a return to greater regulation of this market must be seen as wholly inconsistent with the ongoing competitive evolution of the industry.

31. AT&T has asserted that the Commission's Price-Flex triggers are too lenient and, therefore, are allowing price-cap LECs to exercise pricing freedom in areas where they do not, in fact, face adequate competitive discipline to yield prices that are just and

⁹ The two major changes to special access regulation adopted in the *CALLS Order* were: (1) the establishment of a separate basket of special access services; and (2) the adoption of a non-productivity-related X-factor adjustment that was meant simply to reduce special access rates at a given pace. See Sixth Report and Order in CC Docket Nos. 96-262 and 94-1; Report and Order in CC Docket No. 99-249; Eleventh Report and Order in CC Docket No. 96-45, *Access Charge Reform; Price-cap Performance Review for Local Exchange Carriers; Low-Volume Long Distance Users; Federal State Joint Board on Universal Service*, 15 FCC Rcd 12962, 12975 ¶ 30 (2000) ("*CALLS Order*").

¹⁰ Notice at 2001 ¶ 15. See also, *CALLS Order* at 12964, 12974, 12977 ¶¶ 1, 29, 36.

reasonable.¹¹ SBC's experience demonstrates that AT&T's allegations are unfounded, and illustrates well the economic success of the Price-Flex/*CALLS* regime. SBC has met the criteria for price flexibility for the majority of its special access service business. The markets served by SBC span a large portion of the U.S. and encompass small, medium, and large MSAs.¹²

32. The most detailed data available regarding SBC's experience with pricing flexibility come from Mr. Casto's Declaration, which describes an external study of 37 of the MSAs in which SBC has been granted Phase II pricing flexibility.¹³ These 37 MSAs account for approximately [BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION] of SBC's Phase II revenue.¹⁴ The available data speak directly to key concerns and questions raised in the NPRM.

33. **Entry Conditions in Special Access Services.** The data on entry reveal that, in nearly every market studied, SBC is facing increased competition from new entrants. Figure 1 shows the number of SBC's competitors providing, or able to provide, special access services in each year from 1999 through 2004, and Figure 2 lists SBC's competitors that could be identified in each MSA over the same time period. In Figure 1, the first year of Phase II flexibility is indicated by bolded italics, as are subsequent years. Clearly, net new entry has occurred across the board throughout the 1999-2004 period. Moreover, competitive entry has continued following the granting of Phase II price flexibility for SBC.

34. As new entrants take root in the market, they provide customers with a widening range of competitive alternatives and strategies. Mr. Casto provides a detailed discussion of the characteristics and strategies of many of the competitors SBC (and other price-cap

¹¹ Notice at 2001 ¶ 6.

¹² See Casto Declaration ¶ 17-19 and 21-24.

¹³ *Id.* ¶ 55.

¹⁴ See *id.* ¶ 55.

LECs) confronts in the marketplace.¹⁵ As he notes, in addition to competitive local exchange carriers (CLECs) who have collocated in price-cap LECs' wire centers or taken up residence in collocation "carrier hotels," competition has also come from providers of competitive fiber (including wholesale fiber owners and CLECs who have laid their own fiber), cable companies, and fixed wireless providers—all of whom are able to completely bypass the price-cap LEC's facilities.¹⁶

35. At least two salient characteristics of the competition faced by price-cap LECs like SBC stand out in the evidence summarized in Figures 1 and 2. *First*, even in relatively small markets where Phase II flexibility has been granted, such as Hartford, Connecticut, and Rockford, Illinois, we see multiple competitors present as alternatives to the price-cap LEC. The steady upward trend of net entry and resulting alternative providers present in these markets indicates that this has not been a one-time euphoric burst. Many competitors who entered several years ago have evidently found that the market can support them. *Second*, the steady rise in the number of entrants present in the varied markets described in Figures 1 and 2 provides strong evidence that barriers to entry are not high enough to block the disciplining effects of competition. If the data suggested insurmountable barriers to entry, we might expect instead to see a pattern of no competition followed by an abrupt and short-lived burst of entry when the incumbent LEC (was irrational or poorly informed enough to) set its prices high enough to invite such entry.

36. The evident robust competitive entry in SBC's markets is an especially clear sign of a healthy market that is not plagued by barriers to entry that preclude reliance on competition as the primary regulator of prices. Modern economics places particular emphasis on the conditions of entry as a determinant of the vigorousness of

¹⁵ See *id.* ¶¶ 11-53.

¹⁶ See *id.*

competition.¹⁷ Even in markets in which only a small number of firms are operating, the discipline of competition emanating from the potential for new competitors can be potent when entry is not substantially impeded by insurmountable barriers. In fact, these basic principles are recognized in Commission findings regarding the absence of barriers to entry for such special access services as OCn transport and packet-switched services.¹⁸ As discussed in more detail below, the economics of such findings suggest the propriety of across-the-board price flexibility for these services.

37. In the case at hand, it is evident from the fact of ongoing net entry and growth in the numbers of actual competitors that there are no insurmountable barriers to entry in the special access service market. Robust entry in most geographic areas tells us that the market for special access services is generally subject to entry and its disciplining impact; barriers to entry are low enough and margins sufficient to lure in new providers should the incumbent attempt to raise prices significantly above competitive levels. The very threat of entry forces competitive responses from incumbents, who find it necessary to lower prices or improve their products, or both, in an effort to retain customer loyalty.

38. Mr. Casto describes SBC's responses to the many competitors detailed in Figures 1 and 2 and, in addition, those additional competitors that must reasonably be expected to

¹⁷ See William Baumol, John Panzar, and Robert Willig *Contestable Markets and the Theory of Industry Structure*, Revised Edition, Harcourt Brace Jovanovich, 1988, at 498-499.

¹⁸ Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Deployment of Wireline Services Offering Advanced Telecommunications Capability*, 18 FCC Rcd 16978, 16998-99, 17170, 17223, 17324-26 ¶¶ 318, 393, 545-46 (2003) ("Triennial Review Order"), vacated in part sub nom. *United States Telecomms. Ass'n v. FCC*, 359 F.3d 554 (D.C. Cir. 2004), cert. denied, *National Ass'n of Regulatory Utility Comm'rs v. United States Telecomms. Ass'n*, 125 S. Ct. 313 (Oct. 12, 2004), on remand, Order on Remand, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, WC Docket No. 04-313, CC Docket No. 01-338, FCC No. 04-290 (rel. Feb. 4, 2005).

enter the market if prices rise above competitive levels.¹⁹ This type of dynamic environment is precisely the response the Commission presumably hoped for when it adopted its *Pricing Flexibility Order* and, subsequently, its *CALLS Order*, described as a “five-year interim regime designed to...move towards a more market-based approach to ratesetting.”²⁰

39. The evidence that the special access market has sustained entry of many new competitors speaks to at least two additional concerns emphasized by the Commission in the NPRM: (1) that the MSA may be too broad as a market definition in Price-Flex analysis;²¹ and (2) that incumbent LECs may have used pricing flexibility to design pricing structures that are themselves barriers to entry. Let us consider these issues in turn.

40. **MSAs and sub-MSAs.** The evidence that barriers to entry are not impeding the discipline of competition means that, even in those areas where the incumbent LEC may still have a high share of sales, its position is not secure. Non-competitive conduct in terms of pricing and service offerings by the incumbent can only make it a target for entry—and such entry is viable. Consequently, we can expect the disciplining effect of competition to affect the incumbent even if the incumbent is not immediately facing numerous existing alternative carriers in portions of an MSA. Thus, while it stands to reason that more firms would actually operate in portions of an MSA that are more densely populated by customers, if the incumbent does not behave competitively in less dense areas, it can create the conditions that attract actual entrants to eat away at its customer base.

41. In fact, as Mr. Casto points out, alternative providers are not only imposing the disciplining effect of the threat of entry to entire MSAs; they are also increasingly directly

¹⁹ See Casto Declaration ¶ 64-65.

²⁰ Notice at 2000 ¶ 14.

²¹ Notice at 2023-24 ¶ 88, citing AT&T Reply, Reply Declaration of Lee L. Selwyn.

serving even relatively less dense portions of MSAs and entire MSAs.²² Specifically, the laying of more and more non-LEC fiber, the appearance of now-viable fixed wireless options, progress on broadband-over-power-line service, entry into the voice and data market by cable television companies that have already sunk their basic infrastructures, and related developments are all expanding the range and types of MSA coverage of alternative providers.

42. SBC's own conduct is consistent with the conclusion that relative ease of entry and the expansion of competitors subject even smaller MSAs (and slower-growing and less dense portions of MSAs) to the disciplining forces of competition. Mr. Casto describes a number of the marketing approaches that SBC has implemented in the increasingly competitive environment it confronts.²³ As discussed further below, contract offerings such as SBC's MVP plan attempt to attract customers by offering them price/term/volume mixes that fit their demands for stable, long-term, value-enhancing service. Notably, SBC generally offers these contracts to wholesale customers on an MSA-wide basis, without regard to the number of collocated competitors in individual wire centers or other such factors.²⁴

43. Based on the evidence in these markets and SBC's practices, it is proper to conclude that there is little danger that, in Phase II MSAs, SBC could exercise market power in wire centers with few collocators. First, the steadily growing competitive impact of intermodal providers, described in detail by Mr. Casto, constrains prices even in those wire centers in which such providers are not yet active. Second, if SBC attempted to price its services monopolistically in certain wire centers, its own wholesale customers could profitably undersell those services in the resale market, since these customers buy those services at MSA-wide prices. Finally, the availability of unbundled

²² See Casto Declaration ¶ 43, 45.

²³ See *id.* ¶ 59-60, 64-67.

²⁴ See *id.* ¶ 64.

network elements allows eligible providers to obtain the same functionality as special access services at TELRIC-based rates if special access rates are higher.

44. **LEC Marketing and Contracting.** The evidence of the steady net entry of LEC alternatives in MSA after MSA also speaks to concerns raised in the NPRM regarding possible competition-dampening effects of incumbent carriers' marketing strategies. As described by Mr. Casto, SBC does indeed employ plans that compete for customers' business by offering them attractive pricing for high volume and longer-term use of SBC service offerings. SBC's primary longer-term discount program, MVP, provides eligible customers with additional discounts, ranging from 9% the first year to 14% the fifth year. The MVP program, and other similar programs introduced by other price-cap LECs, is a direct response to competition as SBC works to retain its customers by improving its price and service offerings relative to the competition.

45. Customers want these offerings, and the fact that SBC and other ILECs offer them is a competitive, market-based response. Customers seek these sorts of pricing plans because they see them as offering preferable pricing and quality. They demand such concessions in return for their high-volume and longer-term business, and, as Mr. Casto explains, frequently abandon SBC for competitors that offer even more attractive packages. Indeed, in [BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION] of the 283 [BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION] instances of individually negotiated contracts reported by SBC, it was unable to offer a deal good enough to keep the customer.²⁵

46. Volume and term discounts of the type that SBC, other LECs, and their competitors offer are common in competitive markets. Examples include: the virtually universal practice of scores of magazine publishers offering discounts to consumers who commit to long-term subscriptions (relative to month-to-month spot purchases); discounts offered by innumerable independent home heating oil dealers if customers commit to an

²⁵ See *id.*

annual contract (as opposed to as-needed, single-delivery options); the ubiquitous practice of apartment owners offering lower prices on longer-term rentals in exchange for loss-of-deposit penalties for the breaking of long-term leases; and the institution of take-or-pay contracting in natural resources (such as natural gas) under which customers (i.e., utilities that resell gas) purchase volumes subject to the requirement that minimum volumes be paid for even if not taken by the buyer.

47. Volume and term discounts are used and sustained in competitive markets because they promote efficiency and consumer welfare. In particular, volume and term discounts are consistent with efficient and competitive markets because of such factors as: they hold down sellers' risks and costs of dealing with risks attendant to unpredictability in sales flows and associated utilization of investments; they allow product offerings to be tailored more tightly to customers' varying demands for predictability and consistency in product delivery and pricing; and they conserve on firms' marketing costs, consumers' search costs, and firms' and consumers' transactions costs.

48. I understand that the above-mentioned MVP requires a minimum annual revenue commitment (MARC) equal to the customer's previous three months' purchases, annualized.²⁶ Volume and term discounts with a MARC-like requirement—that is, a volume commitment based on a customer's past spending patterns—would help an LEC achieve several objectives in a competitive market. In particular, such discount plans provide LECs with revenue assurances and stability, which helps to keep their cost of capital low. That enhances the ability of these LECs to make the investment necessary to build, maintain, and upgrade their networks to meet expected demand with at least some degree of certainty that the facilities will not be stranded, and that they will be able to recover sunk costs.

49. Further, even if LECs conceivably hoped that volume and term discounts would impede competition by making it harder for entrants to get a foothold, such hopes have

²⁶ See *id.* ¶ 60.

been in vain. The steady rise in providers in market after market seen in Figures 1 and 2 indicates that pricing flexibility, including the flexibility to offer contract-term and volume discounts, has not impeded entry or competition. Thus, rather than being an aggressive tool used to prevent competition, volume and term discounts have been a response to competition and an effort (as Mr. Casto explains) to meet customers' demands. Indeed, were the Commission's triggers systematically erring by granting pricing flexibility in areas where price-cap LECs were not subject to competition, we would not expect to see widespread use of volume and term discounts or increasing reliance on individual contract tariffs in Phase II markets. Those attributes reflect a market in which mutual competitors feel pressure to better tailor their offerings to match customers' demands as well as or better than the next provider. The evidence of the progress of competition in special access services belies the contention that such contracts somehow coerce buyers who have few competitive alternatives to be locked into doing business with the price-cap LECs, thereby anticompetitively impeding the entry of alternative suppliers.²⁷

50. In any event, in this market, incumbent LECs cannot force any customer to accept any volume-discount plan in the first place. Incumbent LECs are required to file a standard offer that provides any customer with a backstop service if that customer does not desire to strike a long-term negotiated relationship with the LEC. While under Phase II flexibility the caps are removed from such standard offers, SBC has generally not raised its standard rates in Phase II MSAs, and its average prices are now lower overall than when *CALLS* began in 2000.²⁸ Customers have ready access to SBC's standard offer, not to mention the offerings of competitors (including both those that collocate in an SBC wire center and those intermodal and intramodal providers that do not).

²⁷ Notice at 2032 ¶ 116.

²⁸ See Casto Declaration ¶ 56.

C. Declining Special Access Service Prices

51. AT&T complains that the granting of price flexibility in special access services has not left Price-Flex LECs subject to competitive discipline because, according to AT&T, prices charged by such LECs have not declined since the granting of price flexibility. To begin with, this claim is economically unsound: competitive markets do not imply perpetually declining prices. After all, competitive markets raise and lower prices as supply and demand conditions wax and wane. Nevertheless, the NPRM expresses interest in whether prices in Price-Flex MSAs have fallen in response to the competitive conditions that trigger Phase II price flexibility.²⁹ Average prices have generally dropped in SBC's Phase II MSAs, at every level of service, compared to the rates in effect in 2000.³⁰ While declining prices are not infallible indicators of competition (just as rising prices do not invariably indicate the absence of competition), the declines seen relative to when flexibility went into effect suggest that Phase II flexibility has not unleashed otherwise suppressed LEC market power.

52. As detailed by Mr. Casto, based on a study of areas where pricing flexibility has been granted, SBC's prices for DS1 and DS3 services declined [BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION] and [BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION] respectively, between 2000 and 2004.³¹ SBC's generally declining prices are evident in Figure 3, which shows price trends in the MSAs analyzed in Mr. Casto's Declaration.

53. The declining price trend is also seen in prices being charged by CLECs for special access services in the same markets where SBC has been granted pricing flexibility. If the granting of Phase II price flexibility had somehow unleashed price-cap LEC market power and pushed prices upward, CLECs' prices would be expected to have

²⁹ Notice at 2018-19 ¶ 70-71.

³⁰ See Casto Declaration ¶ 56.

³¹ See *id.*

followed Price-Flex LECs' prices on their rise. The survey of 37 SBC MSAs, described in Mr. Casto's Declaration, covered many of the regions where SBC has Phase II pricing flexibility. This data shows that CLEC prices consistently have been trending *downward* since 1999, and that downward trend has persisted following the granting of Phase II pricing flexibility. The "unleashing market power" hypothesis has no support in this evidence.

D. Summary

54. Claims that the competitive triggers specified in the *Pricing Flexibility Order* allow price-cap LECs to receive price relief in areas where they do not actually face competitive discipline are not supported by the evidence. In markets where the Commission has granted SBC price flexibility, prices of special access services have typically declined, firms have aggressively offered price discounts to compete for special access business, and numerous new providers have entered market after market. All of this evidence supports the conclusion that the triggers effectively identify markets in which competition exists and price-cap LECs should be allowed flexibility to compete on the basis of price. Indeed, as the triggers only account for collocation-based competition, they are conservative measures.

55. The Price-Flex/*CALLS* regime has turned out to be well-matched to the evolving markets for special access services. It provides a reasonable approach to protecting against the prospect of non-competitive conditions during a transition to what is clearly now an industry characterized by ongoing technological change, robust entry by heterogeneous firms deploying a multiplicity of technologies and strategies, and greater choice for customers. Nothing in the evidence implies a need to roll back the path of reform the Commission has followed since eschewing outdated rate-of-return regulation in the early 1990s. The scheduled expiration of *CALLS* in 2005, however, raises the question of proper design of the next phase of policy reform affecting interstate access. I turn to this now.

IV. POLICY GUIDELINES FOR THE POST-CALLS REGULATORY REGIME

56. As discussed above, price regulation is poor policy in competitive markets. Since the evidence reveals that competition is robust where the Phase II triggers have been met, it follows that reimposition of price-caps would be inappropriate in those markets. I conclude further that, since OCn-level services and packet-switched services are competitive on a national basis, those services should be given unregulated price flexibility. In addition, since incumbent LECs need flexibility to meet customer demands for downward price flexibility in all markets, and since LECs pose no danger of predatory pricing, Phase I pricing flexibility is appropriate nationwide. Finally, none of the reregulation proposals suggested by AT&T and its supporters—including rate-of-return or reinitialized price-cap regulation and X- or g-factors—make sound policy sense given the state of this market.

A. Adequacy of the Price-Flex/*CALLS* Regime

57. The Price-Flex/*CALLS* regime is consistent with two key insights about the economics of price regulation which give it its economic coherence and support my recommendation that the regime not be “rolled back.” *First*, the Commission’s price flexibility regime embodies the sound principle that price regulation is unnecessary, and often downright counterproductive, in markets that become competitive. *Second*, the Commission’s policy of pricing flexibility embodies recognition of the need for policy to transition along with the industry. It is impractical and distorting to the economy to continue to tightly regulate the prices and service offerings of one firm as if it were still a natural monopoly when, all around it, that firm is subject to competition from increasing numbers of dynamic, innovative, and *unregulated* competitors.

58. The lesson in the negative is the U.S. Postal Service. Limited so as to ensure that it not earn exorbitant profits,³² and although putatively protected by having exclusive franchises and access to subsidies, the Postal Service has ended up a stagnant, money-

³² I.e., economically tantamount to maximum allowed rate-of-return regulation.

losing enterprise as innovative and aggressive competitors have eaten into and come to dominate service standards in package delivery and high-priority mail.³³ Inducing stagnation via regulation in this way is an object lesson of what *not* to do in telecommunications.

59. **The Price-Flex Triggers.** As transitional policy, the evidence reviewed above indicates that the Commission's pricing flexibility regime is striking an appropriate balance by proceeding toward greater price flexibility for LECs as incumbent price-cap LECs face greater competition in their markets. In fact, the Commission's Price-Flex triggers are conservatively designed. While they recognize the critical role that entry plays in ensuring the competitiveness of special access service markets, the competitive triggers set in 1999 do not incorporate the degree of competition faced by price-cap LECs as a result of entry (and the prospect of entry) by competitors that do not share their facilities. Specifically, the Commission's triggers focus on collocation of competitors in price-cap LECs' wire centers, but do not weigh competition from owners of competitive fiber who have placed facilities and equipment in locations (e.g., carrier hotels) other than a price-cap LEC's central office. Nor do the triggers recognize the growing intermodal competition from emerging technologies deployed by cable and fixed wireless providers.

60. As indicated in Figure 2, entry in recent years into special access service markets is notably marked by the increasing presence of cable companies (such as Cox Communications and Comcast) with capabilities to provide wholesale service at bandwidths ranging from DS1 to OC48, as well as fixed wireless providers with similarly wide-ranging capability (such as XO Communications and First Avenue Networks).³⁴ As Mr. Casto documents, these kinds of carriers often already have networks installed that span essentially entire MSAs (as with the cable television companies), or networks that can readily enter and span very broad geographic areas (in the case of fixed wireless). As

³³ See Michael A. Crew and Paul R. Kleindorfer, "Developing Policies for the Future of the United States Postal Service," in *Competitive Transformation of the Postal and Delivery Sector*, Kluwer Academic Publishers, 2003.

³⁴ See Casto Declaration ¶¶ 37-53.

the number and penetration of intermodal substitutes for special access services increase, competitive triggers that do not incorporate the degree of intermodal competition provide notably conservative measures of the degree of competition facing price-cap LECs.

61. **Baskets and Sub-Baskets.** Services lacking barriers sufficient to deter efficient entry and the accompanying competitive discipline of such entry do not warrant continued regulation. This conclusion applies to certain services on the national level. In concluding that OCn loops and OCn transport do not meet the UNE “impairment” test, the Commission found evidence that competitive indicia for these services exist nationwide.³⁵ Based on these same indicia, such services appear ripe for blanket application of Phase II flexibility. Independent of the Price-Flex triggers, the evidence cited by the Commission implies that existing and potential competitors discipline the price an incumbent LEC could charge for such services. For these services, the transition to market-based pricing conditions has been achieved, and further regulation is unnecessary.

62. For similar reasons, the Commission should keep packet-switched services out of price-caps. Their complete deregulation is justified by Commission findings regarding the robust and full-formed competition in the data services market in the *Triennial Review Order*.³⁶ Accordingly, as with OCn loops and transport services, the pricing of packet-switched services does not need to be subjected to regulatory price constraints.

63. The Price-Flex/*CALLS* system properly accounts for the remaining pockets of services that may not be fully competitive. Certain special access services may be less susceptible in particular circumstances to full competition from multiple providers, and in these situations, transitional regulatory oversight of pricing and price flexibility is warranted. The existing regime’s use of higher triggers for lower-bandwidth services, such as end-user channel terminations, helps protect consumer interests in these

³⁵ Triennial Review Order at 16998-99, 17176, 17223 ¶¶ 318, 393.

³⁶ *Id.* at 17324-26 ¶¶ 545-46.

remaining pockets; the existing criteria adequately, if conservatively, reflect the level of competition that would warrant greater flexibility.

64. **Bundling Issues.** The NPRM notes concerns that bundling might constitute anticompetitive tying of access to a non-competitive service to required purchase of a prospectively competitive service, and thereby lock down customers and impede competition in the latter.³⁷ Even if some services (such as end-user channel terminations in a particular MSA) are not yet subject to full competition, customers should remain free to purchase bundles of services that include both those services and deregulated or Price-Flex services, so long as the resulting bundle does not involve predatory pricing (i.e., below variable cost) for the competitive product. Sound policy here merely requires that the more regulated service be available on an unbundled basis at its capped rates. Such unbundling in this context ensures that no putative market power over a still-capped service can be extended to other services of the LEC. SBC's own practice is to offer both bundled and unbundled options, consistent with sound policy.

65. **Extension of Phase I Pricing.** The Commission notes in the NPRM that it has been concerned in the past that "some large discounts might be anticompetitive."³⁸ Beyond concerns (albeit lacking foundation—see above) raised regarding volume and term discounts, it is not plausible to argue that predatory pricing has been a practice, much less an effective practice, of Price-Flex LECs. Predatory pricing is a profitable strategy if the firm can drive competitors out of a market by pricing below variable cost and afterwards increase prices to recoup losses incurred during predation.³⁹ But a firm cannot succeed in this strategy, and will indeed be worse off because of it, if it cannot in fact recoup short-term losses by raising prices to supracompetitive levels. In Phase I MSAs, however, price-caps prevent such recoupment, and thus foreclose concern about predatory pricing. Moreover, as discussed above, continuing competitive entry in market

³⁷ Notice at 2033 ¶ 119-21.

³⁸ *Id.* at 2031-32 ¶ 115.

after market demonstrates that Phase I and Phase II Price-Flex LECs have not set prices that are anticompetitively low and succeeded in precluding entry. They could not reasonably hope to succeed in recouping losses from some putative predatory strategy.

66. From a policy perspective, these findings imply that Phase I flexibility could now properly be granted on a nationwide basis and without the necessity of applying screening triggers—as the Commission suggests would now be called for.⁴⁰ The presence of standard-offer service at regulated rates stands as a backstop of customer protection against exercises of market power in those markets not ready for Phase II flexibility, while expansion of Phase I would expand the benefits of contractual tariffs to many more customers.⁴¹ Moreover, as the triggers do not pick up the presence of non-located and intermodal competition, it is less likely that a LEC could exercise market power in any context where the collocation alone might suggest otherwise. Nationwide Phase I pricing would constitute a wise balance in regulatory policy for special access services.

B. Calls for Return to Increased Regulation

67. In its petition, AT&T asserts that the Commission's competitive triggers fail to accurately identify markets with significant competitive pressures and that pricing flexibility has been granted where competitive entry has not occurred.⁴² Based on its assertion that the Commission's triggers do not accurately identify the existence of price-constraining competition, AT&T requests that the Commission impose a pricing flexibility moratorium; that pricing flexibility be "revisited" (and presumably eliminated in its current form); and that price-cap LECs be required to reduce ("reinitialize") their special access rates to levels that would generate an 11.25% rate of return until this

³⁹ W. Kip Viscusi, John M. Vernon, and Joseph E. Harrington, *Economics of Regulation and Antitrust*, The MIT Press, 1998, at 274-275.

⁴⁰ Notice at 2014 ¶ 56.

⁴¹ See Casto Declaration ¶ 71.

⁴² Notice at 2002-2003 ¶ 19.

rulemaking proceeding is concluded.⁴³ The NPRM seeks comments on these proposals, and also asks whether any rollback of price-cap LECs' prices should be accompanied by reimposition of, for example, an X-factor or a g-factor.⁴⁴ Such proposals are deeply at odds with sound economic considerations.

68. **Abandoning Price Flexibility.** As I have already stressed, the evidence on market performance under price flexibility and *CALLS* and the economics of sound regulatory design indicate that rolling back prices by reimposing rate-of-return criteria would constitute a highly regrettable retrogression in the nation's telecommunications policy. AT&T's assertion that many areas attaining price flexibility are not, in fact, competitive is inconsistent with the data discussed above. The Price-Flex triggers have properly (if conservatively) identified those areas in which competition is mature. The evidence on competitor entry and declining prices demonstrates that, in those areas that have met the triggers, prices are effectively constrained by competitive forces. The granting of price flexibility is not unleashing suppressed market power.

69. Although the transition to competition has progressed at different speeds across MSAs, asymmetry across markets does not imply that the current regulatory framework is flawed, as some have claimed.⁴⁵ The transition to competition does not always lead to symmetric reductions in prices across markets. Indeed, if the regulated price were set *below* what would exist in a competitive market, deregulation would initially cause the price to *rise*. Thus, increases in the price of service in such markets do not imply failure of the current regulatory framework. Basing a decision to broadly reinstitute price regulation on relative, short-term price increases in a subset of markets does not constitute sound public policy.

70. Most fundamentally, changing the "rules of the game" by reversing regulatory direction at this point would threaten the industry's trust in the Commission's basic

⁴³ *Id.*

⁴⁴ *Id.* at 2011 ¶¶ 45-47.

⁴⁵ *Id.* at 2002-03 ¶ 19.

commitment to a competitive, deregulated market in the long term. The abandonment of pricing flexibility would send a signal that investment in efficiency and innovation designed to allow incumbent LECs to keep pace with the dynamic evolution of their markets is ultimately subject to regulatory renegeing. And the prospect of price-lowering regulation would likewise depress the incentives of facilities-based competitors to enter the markets subject to such regulation.

71. **Use of Downward Price Ratchets.** Historically, an “X-factor” was designed to reflect industry-specific productivity enhancements, and it applied company-wide rather than to particular service categories. The X-factor used in the first few years of the *CALLS* plan, however, was never viewed as a productivity factor. It was instead simply an agreed-upon mechanism for lowering rates as part of an industry-wide compromise for reforming interstate compensation rules for all switched and special access traffic.⁴⁶

72. Since the beginning of 2004, rate caps (as employed when flexibility has not been granted and in the backstop standard-offer rates under Phase I flexibility) have been adjusted upward for general inflation as measured by the Gross Domestic Product-Price Index (GDP-PI). At the same time, rate caps have been subjected to reduction by an X-factor equal to inflation as measured by the GDP-PI. Thus, as the NPRM points out, rate caps have been frozen at their 2003 level.⁴⁷ In fact, this is a freezing in nominal (not inflation-adjusted) terms. Economically, real rate caps are actually being forced steadily down: in real terms (i.e., after adjustment for the negative impact of inflation), rate caps have not been permitted to keep pace with inflation and have become lower relative to the general price level for all other goods in the economy.

73. Resetting price-caps to include an enterprise-wide, productivity-based X-factor is not justified given the nature of costs and the degree of competition facing different classes of special access services. Services vary in the technology they employ and thus vary in their potential to achieve future efficiency gains. As explained in the declaration

⁴⁶ *Id.* at 2000-01 ¶ 15.

⁴⁷ *Id.*

of John Klick and Michael Baranowski, even different special access services are subject to different levels of productivity. OCn services, which are fiber-based, might have different productivity gains than services based on older technology. Productivity gains for many of these technologies, such as copper wiring and telephone poles, have arguably been exhausted.⁴⁸

74. In any event, the evidence is lacking that there yet remains “fat” to be wrung out of special access services, as there might have been when the Commission first imposed price-caps on these services which previously had been regulated under rate-of-return principles that discouraged efficiency. These services have now been subject to almost fifteen years of incentives for efficiency under a price-cap regime that encourages price-cap LECs to hold costs below the caps. And under *CALLS*, these services were subject to several years of aggressive X-factor reductions. Including a new X-factor now to capture additional, predictive productivity gains is unreasonable given the lack of evidence that there is a serious potential for improving productivity. Further, as Mr. Klick and Mr. Baranowski explain, setting a reliable predictive factor is an uncertain exercise.⁴⁹ Also, given that LECs face inter- and intramodal competition even in price-cap areas, the imposition of an overly aggressive productivity adjustment could do serious harm to competition by skewing the market and reducing and distorting incentives for competitive entry.⁵⁰

75. The same conclusion applies to consideration in the NPRM of reimposition of a “g-factor” (i.e., ratcheting rates down as output grows).⁵¹ A g-factor was previously justified by a regulatory framework which saw price-cap LECs as having such strong economies of scale and scope that they naturally tended toward being the large monopolistic carrier in the markets they served. Accordingly, it was reasoned, as LECs’

⁴⁸ See Klick & Baranowski Declaration ¶ 20.

⁴⁹ See *id.* ¶ 14.

⁵⁰ See *id.* ¶ 24.

⁵¹ Notice at 2009-10 ¶ 38-40.